7

No. 98-2043

In The

# Supreme Court of the United States

HUNT-WESSON, INC.,

*Petitioner,*

v.

FRANCHISE TAX BOARD,

*Respondent.*

**On Writ Of Certiorari
To The Court Of Appeal Of California
For The First Appellate District**

## BRIEF FOR PETITIONER

DREW S. DAYS III
127 Wall Street
New Haven, CT 06520
(203) 432-4948

WALTER HELLERSTEIN
University of Georgia Law School
Herty Drive
Athens, GA 30602
(706) 542-5175

CHARLES J. MOLL III
(*Counsel of Record*)
EDWIN P. ANTOLIN
MORRISON & FOERSTER LLP
425 Market Street
San Francisco, CA 94105
(415) 268-6497

FRED O. MARCUS
HORWOOD, MARCUS & BERK, CHARTERED
333 West Wacker Drive, Suite 2800
Chicago, IL 60606
(312) 606-3210

*Counsel for Petitioner*

COCKLE LAW BRIEF PRINTING CO., (800) 225-6964
OR CALL COLLECT (402) 342-2831

9188

## QUESTIONS PRESENTED

1. Under the Commerce and Due Process Clauses, a State may not tax the dividends that a nondomiciliary corporation receives from its nonunitary subsidiaries. *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768 (1992); *ASARCO, Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307 (1982); *F.W. Woolworth Co. v. Taxation & Revenue Dep't*, 458 U.S. 354 (1982). California law nevertheless requires that a nondomiciliary corporation reduce its deductible net interest expense – and thereby increase its apportionable income subject to tax – by the amount of such exempt dividends. Moreover, this requirement applies even when the disallowed interest expense is unrelated to the production of the exempt dividend income. The question presented is:

> Whether a State may tax constitutionally exempt income under the guise of denying a deduction for expenses in an amount equal to such income when there is no evidence that the expenses relate to the production of the exempt income?

2. Whether a State tax discriminates against interstate commerce in violation of the Commerce Clause by disallowing an otherwise deductible expense, thereby increasing California taxable income, solely because the corporation is not domiciled in the State or does not have subsidiaries that engage in taxable in-state activity?

## LIST OF PARTIES

The parties are as stated in the caption. In the courts below, the petitioner was referred to as Hunt-Wesson, Inc., Successor in Interest to Beatrice Companies, Inc., and as Hunt-Wesson, Inc., formerly known as Beatrice/Hunt-Wesson, a Successor by Merger with Beatrice Company, formerly known as CagSub, Inc., a Successor in Interest to Beatrice Companies, Inc., formerly known as Beatrice Foods Company.

## RULE 29.6 STATEMENT

Hunt-Wesson, Inc. is a wholly owned subsidiary of ConAgra, Inc. Its non-wholly-owned subsidiaries are ConAgra Brands, Inc. and ConAgra Limited.



## TABLE OF CONTENTS

TABLE OF CONTENTS – Continued





TABLE OF AUTHORITIES

TABLE OF AUTHORITIES – Continued





TABLE OF AUTHORITIES – Continued



STATUTES

TABLE OF AUTHORITIES – Continued





TABLE OF AUTHORITIES – Continued

## OPINIONS BELOW

The Opinion of the Court of Appeal (J.A. 54-66)[1] is not officially reported. The judgment and statement of the Superior Court of California, City and County of San Francisco (J.A. 33-53), is not officially reported. The California Supreme Court's denial of Hunt-Wesson's petition for review (J.A. 67) is not officially reported.

## JURISDICTION

The judgment of the Court of Appeal was entered on December 11, 1998. The Supreme Court of California denied Hunt-Wesson's petition for review on March 24, 1999. J.A. 67. The petition for certiorari was filed on June 22, 1999, and was granted on September 28, 1999. The jurisdiction of this Court rests on 28 U.S.C. § 1257(a).

## CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The Commerce Clause of the United States Constitution, U.S. Const. art. I, § 8, cl. 3, provides: "The Congress shall have Power . . . [t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes."

---

[1] References to the Joint Appendix are denominated "J.A." followed by a page reference. References to the Appendix to the Petition for Certiorari are denominated "Pet. App." followed by a page reference.

The Due Process Clause of the Fourteenth Amendment to the United States Constitution, U.S. Const. amend. XIV, § 1, provides: "No State shall . . . deprive any person of life, liberty, or property, without due process of law."

Relevant portions of the California statutes are set forth at Pet. App. 35a-38a.

## STATEMENT

This case involves a dispute over California's denial of an income tax deduction to nondomiciliary corporations. California's corporate income tax law generally provides that "there shall be allowed as a deduction all interest paid or accrued during the income year on indebtedness of the taxpayer." Cal. Rev. & Tax. Code § 24344(a). However, through its so-called "interest offset" provision, California modifies this general principle for nondomiciliary corporations in a manner that is constitutionally indefensible for three discrete reasons.

First, California denies nondomiciliary corporations an interest expense deduction in an amount equal to constitutionally nontaxable dividends. California denies this deduction even when the disallowed interest expense bears no relationship to the constitutionally nontaxable dividends. As a consequence, California increases a nondomiciliary corporation's taxable income base by an amount equal to the nontaxable income, effectively taxing income that lies beyond California's constitutional reach.



Second, California permits domiciliary corporations, but not nondomiciliary corporations, to reduce their taxable income by interest expense to the extent that the corporation receives dividends from nonunitary corporations. The preferential treatment persists regardless of whether the interest expense bears any relationship to the production of the dividends in question. Because the allowance or disallowance of the deduction turns entirely on the domicile of the dividend-receiving corporation, it violates the cardinal principle of this Court's Commerce Clause jurisprudence barring taxes that facially discriminate in favor of in-state over out-of-state entities.

Third, California provides a selective exception to the rule denying nondomiciliary corporations an interest expense deduction: It permits a nondomiciliary corporation to deduct interest expense without regard to its receipt of constitutionally nontaxable dividends, but *only* if the dividends are received from corporations that engage in taxable activity in California. This limited exception to the rule disallowing nondomiciliary corporations an interest expense deduction, however, runs headlong into the Commerce Clause prohibition against state taxes that condition a tax benefit (the deductibility of interest expense) upon the extent of a corporation's in-state investment.

In short, California's attempt to curtail the availability of its interest expense deduction to nondomiciliary corporations is riddled with constitutional defects, any one of which is sufficient to require its invalidation.

### 1. Beatrice's Business

The facts of this case, which have been stipulated, are not in dispute.[2] Petitioner Hunt-Wesson, Inc. is the successor in interest to the Beatrice Foods Company ("Beatrice"), the original taxpayer in this case. Beatrice was a Delaware corporation with its commercial domicile in Illinois. During the years at issue (fiscal years 1980 through 1982),[3] Beatrice was a diversified company engaged in business within and without California, primarily in providing food and food-related products and services for worldwide markets. Beatrice also produced other consumer, industrial, and chemical products.

Beatrice owned directly and indirectly certain dividend-paying subsidiaries with which it was not engaged in a unitary business (the "nonunitary subsidiaries"). Stip. ¶ 7 (J.A. 19). Most of the nonunitary subsidiaries were incorporated in foreign countries, and none of them was incorporated in California. Stip. ¶ 7 (J.A. 19). The nonunitary subsidiaries paid to Beatrice dividends which were not taxable by California (the "nonunitary dividends") of $26,718,620 for 1980, $29,482,637 for 1981, and $19,022,617 for 1982. Stip. ¶¶ 7, 8 (J.A. 19).

---

[2] References to the Joint Stipulation of Facts in this case are denominated "Stip." followed by a paragraph reference. The Joint Stipulation of Facts is reproduced at J.A. 16-24.

[3] The three fiscal years at issue date from March 1, 1979 to February 29, 1980; March 1, 1980 to February 28, 1981; and March 1, 1981 to February 28, 1982. For ease of reference, we will refer to these years in the text simply as "1980," "1981," and "1982," respectively.



In the operation of its business, Beatrice took out loans and incurred interest expense in connection with these loans. Trial Court Statement of Decision ¶ F (J.A. 35). During the years at issue, the outstanding loans amounted to $793,683,348 for 1980, $610,230,945 for 1981, and $1,312,660,515 for 1982. Stip. Exh. 1 (Clerk's Transcript ("CT") pp. 64-66). The interest expense with respect to these loans amounted to $80,490,469 for 1980, $55,101,503 for 1981, and $137,413,162 for 1982. Stip. ¶ 10 (J.A. 19); Stip. Exh. 1 (CT pp. 64-66). It has never been disputed in this case that "no portion of the proceeds of the loans generating the interest expense deductions herein went directly to any non-unitary corporation, each of which was responsible for its own borrowings (J.S. [Stip.] ¶ 9)." Franchise Tax Board's Objection to Proposed Statement of Decision and Request for Hearing on Objection (CT p. 295) (emphasis omitted). Accordingly, Beatrice claimed a deduction for such interest expense on its California franchise tax returns. Stip. ¶¶ 10, 11, 13 (J.A. 19-20).

### 2. California's Taxing Scheme

California imposes a franchise tax measured by net income on corporations for the privilege of doing business in California. Cal. Rev. & Tax. Code §§ 23151, 23151.1. For a corporation like Beatrice, which is engaged in business within and without the State, California divides the corporation's income into two categories: business income and nonbusiness income. Business income, which is apportioned by formula among all the

States in which the taxpayer does business,[4] means "income arising from transactions and activity in the regular course of the taxpayer's trade or business. . . . " Cal. Rev. & Tax. Code § 25120(a). Nonbusiness income, which generally is allocated to a particular State depending on its situs, "means all income other than business income." Cal. Rev. & Tax. Code §§ 25120(d), 25123-25127.

These definitions are generally "quite compatible with the unitary business principle." *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768, 786 (1992). Under this principle, a State may tax an apportioned share of a nondomiciliary taxpayer's income arising from its unitary business, but generally may not tax income that is not connected with its unitary business (for example, dividend income received from nonunitary subsidiaries).[5] It is stipulated in this case that "[a]ll of th[e] nonunitary dividends received by Beatrice constituted nonunitary, nonbusiness income not subject to apportionment, or taxation, by the State of California." Stip. ¶ 8 (J.A. 19).

[4] The formula determines the portion of the corporation's business income that is fairly attributable to California. During the years at issue, the apportionment percentage was the simple average of three fractions – the taxpayer's in-state property over its total property, its in-state payroll over its total payroll, and its in-state sales over its total sales. *See* Cal. Rev. & Tax. Code §§ 25128, 25129, 25132, and 25134.

[5] If the nonbusiness income has its situs in the State, *e.g.*, income from real property located in the State but unrelated to the taxpayer's trade or business, then the State may, of course, tax a nondomiciliary taxpayer's income from such property. *See, e.g.*, Cal. Rev. & Tax. Code § 25124.



California law generally provides that "there shall be allowed as a deduction all interest paid or accrued during the income year on indebtedness of the taxpayer." Cal. Rev. & Tax. Code § 24344(a). Any interest expense attributable to business income must be subtracted from such income, thereby reducing the income subject to apportionment, and any interest expense attributable to nonbusiness income must be subtracted from such income, thereby reducing the income subject to allocation. *See* Stip. ¶ 11 (J.A. 20). This reflects the widely accepted principle of income tax law and practice generally and in California that expenses should be allocated to the category of income to which they are properly attributable. *See* Cal. Rev. & Tax. Code § 24425; *Great W. Fin. Corp. v. Franchise Tax Bd.*, 4 Cal. 3d 1, 6, 479 P.2d 993 (1971), quoting 12 Marshall, Cal. Practice, State and Local Taxation (1969). There is no dispute in this case about the propriety of this principle.

Rather, the dispute in this case centers on California's so-called "interest offset" provision, contained in Cal. Rev. & Tax. Code § 24344(b), which, during the years at issue, provided:

> If income of the taxpayer is determined by the allocation formula contained in Section 25101, the interest deductible shall be an amount equal to interest income subject to allocation by formula, plus the amount, if any, by which the balance of interest expense exceeds interest and dividend income (except dividends deductible under the provisions of Section 24402) not subject to allocation by formula. Interest expense not included in the preceding sentence shall be directly offset against interest and dividend

> income (except dividends deductible under the provisions of Section 24402) not subject to allocation by formula.

Cal. Rev. & Tax. Code § 24344(b).[6]

For a nondomiciliary taxpayer like petitioner, its interest expense deduction is computed in the following manner.[7] First, as a preliminary matter, the taxpayer must attribute its interest expense to business income or nonbusiness income. Only the former – the "business interest expense" – is subject to the interest offset provision.[8] Second, the taxpayer may deduct its business interest expense to the extent that it has business interest income. Third, the taxpayer must "offset" or reduce the remaining net business interest expense on a dollar-for-dollar basis to the extent of its nonbusiness dividend and interest income, none of which is taxable by California.[9] However, the taxpayer retains the right to the interest expense

[6] The current version of Cal. Rev. & Tax. Code § 24344(b), which is substantially the same as the version in force during the years at issue here, reflects amendments that are not material to this case.

[7] The operation of the interest offset for domiciliary taxpayers is described *infra* at 33.

[8] As the stipulation provides:

> Before the "interest offset" computation was made . . . nonbusiness interest expense . . . was deducted from total interest expense . . . . Thus, the remaining interest expense . . . was business interest expense subject to the "interest offset" computation.

Stip. ¶ 11 (J.A. 20).

[9] *Allied-Signal*, 504 U.S. 768; *ASARCO, Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307 (1982); *F.W. Woolworth Co. v. Taxation & Revenue Dep't*, 458 U.S. 354 (1982); Stip. ¶ 8 (J.A. 19).



deduction, if, but only if, those nonbusiness dividends are received from a corporation deriving taxable income from (and thus doing business in) California.[10] Fourth, if any net business interest expense remains after having been reduced by the amount of the nontaxable, nonbusiness dividends and interest, the taxpayer may deduct such remaining interest expense against its taxable business income.

The operation of this scheme, as described in the preceding paragraph, may be illustrated as follows:

| | | |
|---|---|---|
| Step 1: | | Total Interest Expense |
| | *Less* | Nonbusiness Interest Expense |
| | | Business Interest Expense |
| Step 2: | | Business Interest Expense |
| | *Less* | Business Interest Income |
| | | Net Business Interest Expense |
| Step 3: | | Net Business Interest Expense |
| | *Less* | Nonbusiness Interest Income and Dividends (the "Interest Offset")* |
| | | Remaining Net Business Interest Expense after Interest Offset |
| Step 4: | | Remaining Net Business Interest Expense after Interest Offset |

* Interest expense equal to these amounts is disallowed as a deduction (except dividends paid by corporations taxable in California).

[10] *See* Cal. Rev. & Tax. Code § 24344(b) (providing for interest offset against nonbusiness dividends "except dividends deductible under the provisions of Section 24402"). Dividends deductible under Cal. Rev. & Tax. Code § 24402 are dividends declared from income which has been included in the measure of tax in California.

In substance, then, the interest offset provision sets forth two rules disallowing a deduction for interest expense that is otherwise deductible. The first rule denies a nondomiciliary corporation the benefit of an interest expense deduction by requiring it to allocate its net interest expense to nontaxable income regardless of whether the interest expense bears any relationship to the production of such income. The second rule denies a nondomiciliary corporation receiving nontaxable dividends the benefit of an interest expense deduction unless those dividends are from subsidiaries doing business in California.

### 3. The Assessment

During an audit of Beatrice's tax returns for the years at issue, the Franchise Tax Board (the "Board") applied the interest offset provision and disallowed a portion of Beatrice's interest expense deduction for each year. Stip. ¶ 12 (J.A. 20). Beatrice's total interest expense for the years at issue was $80,490,469 for 1980, $55,101,503 for 1981, and $137,413,162 for 1982, all of which was business interest expense. Stip. ¶¶ 10, 11, 13 (J.A. 19-20). Under the interest offset provision, the Board first permitted Beatrice to deduct the portion of its business interest expense equal to its business interest income, which amounted to $10,217,578 for 1980, $21,389,332 for 1981, and $83,920,105 for 1982. CT pp. 93, 120. The Board then disallowed Beatrice a deduction for its net business interest expense on a dollar-for-dollar basis to the extent of the constitutionally nontaxable dividends that Beatrice received from its nonunitary subsidiaries. Stip. ¶ 12 (J.A. 20). Those dividends amounted to $26,718,620 for 1980, $29,482,367



for 1981, and $19,022,617 for 1982, Stip. ¶ 7 (J.A. 19), which therefore resulted in the denial of an interest expense deduction in the same amounts, namely $26,718,620 for 1980, $29,482,367 for 1981, and $19,022,617 for 1982. Stip. ¶¶ 7, 12 (J.A. 19, 20); CT pp. 93, 120.[11]

The basis for the Board's denial of Beatrice's interest expense deduction was simply that Beatrice had received nonbusiness dividends from its nonunitary subsidiaries. Stip. ¶ 14 (J.A. 21). The Board made no determination that the interest expense bore any relationship to the constitutionally exempt dividends, Stip. ¶ 14 (J.A. 21), and the statute did not require that it do so. As a consequence of the Board's disallowance of Beatrice's interest expense deduction, it increased Beatrice's California business income subject to apportionment by $26,718,620 for 1980, $29,482,367 for 1981, and $19,022,617 for 1982 – the amount of Beatrice's nontaxable dividend income. Stip. ¶ 12 (J.A. 20). This resulted in tax deficiencies of $139,066 for 1980, $170,486 for 1981, and $109,640 for 1982. Stip. ¶ 20 (J.A. 22).

### 4. The Proceedings Below

In March 1996, Beatrice commenced this action by filing a suit for refund of taxes and interest in the

[11] The Board allowed a deduction for Beatrice's remaining business interest expense in excess of its nonbusiness dividend income in the amount of $43,554,427 for 1980, $4,229,804 for 1981, and $34,470,440 for 1982. *See*, CT pp. 93, 120.

Superior Court, City and County of San Francisco.[12] Verified Complaint for Refund of Taxes ("Complaint") (J.A. 4). Beatrice alleged, among other things, that the interest offset provision violated the Commerce and Due Process Clauses of the United States Constitution[13] by arbitrarily limiting its interest expense deduction by the amount of its constitutionally nontaxable dividend income. Complaint ¶¶ 21-22 (J.A. 8).

**(a) The Superior Court.** In June 1997, the Superior Court found that the interest offset provision violated the Commerce and Due Process Clauses. Turning first to the Due Process Clause claim, the court grounded its analysis in two basic, and undisputed, principles: first, "that a State may not tax plaintiff's nonbusiness dividends because plaintiff is a foreign nondomiciliary corporation and such income is only taxable in its state of domicile"; second, "that a state cannot tax indirectly that which it may not tax directly." J.A. 41. These principles, the court reasoned, led inexorably to the conclusion that California's disallowance of Beatrice's interest expense

---

[12] As stipulated by the parties, Beatrice had exhausted all necessary administrative remedies before the Board and the California State Board of Equalization ("SBE") prior to instituting this challenge in court. Stip. ¶ 24 (J.A. 23). Because the SBE lacked jurisdiction to determine the constitutionality of provisions of the California Revenue and Taxation Code, Beatrice and the Board stipulated in August 1995 that Beatrice's administrative appeal would be dismissed without prejudice. Stip. ¶ 24 (J.A. 23).

[13] Beatrice additionally argued at trial and on appeal that the interest offset provision violated the Equal Protection Clause of the Fourteenth Amendment, but is not pressing that claim here.



deduction violated the Due Process Clause because "[i]t disallows interest deductions on a dollar-for dollar basis with non-taxable dividend income without regard to whether or not such interest is *related* to the dividend income." J.A. 45 (emphasis in original).

The court recognized that California might constitutionally deny an interest expense deduction that was related to income that California could not tax. J.A. 44-45. But "such potential legitimate state purpose" (J.A. 45) simply had no application to this case because

> here the parties have stipulated that no portion of the proceeds of the loans generating the interest expense deductions herein went to any nonunitary corporation, each of which was responsible for its own borrowings. (J.S. ¶ 9). Thus, it appears that no portion of the interest expense deduction can be attributable to the generation of the . . . exempt dividends.

J.A. 45.

The court likewise found that the interest offset provision violated the Commerce Clause. Because only domiciliary corporations received any tax benefit from the offset of interest expense against nonunitary dividends, the court observed that it will always be true that "the amount of tax on a foreign corporation under Rev. & T.C. § 24344(b) will be higher than that of a domestic corporation where both have a) the same taxable business income; b) the same interest expense deductions; and c) the same dividend income." J.A. 48. This discrimination against foreign corporations, the court concluded, could not be squared with this Court's precedents barring discrimination against out-of-state corporations. J.A.

47-49 (citing, among other cases, *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996); *Camps Newfound/Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564 (1997); and *Armco, Inc. v. Hardesty*, 467 U.S. 638 (1984)). Moreover, the differential treatment of in-state and out-of-state corporations could not be justified by any purported relationship of the interest expense to the nonunitary dividends, since there was no support in the record for the existence of such a relationship. J.A. 45-46.

**(b) The Court of Appeal.** In December 1998, the Court of Appeal reversed the decision of the Superior Court. The Court of Appeal conceded that, "[i]f we were writing on a clean slate," petitioner's arguments "might appear persuasive." J.A. 61. Nevertheless, the Court of Appeal believed it was bound by a 1972 decision of the California Supreme Court, *Pacific Tel. & Tel. Co. v. Franchise Tax Bd.*, 7 Cal. 3d 544, 498 P.2d 1030 (1972) ("*Pacific Telephone*"), which upheld the Board's statutory interpretation of the interest offset provision (Cal. Rev. & Tax. Code § 24344), even though the Court of Appeal admitted that "the *Pacific Telephone* case did not involve a constitutional challenge to section 24344." J.A. 61.

In rejecting petitioner's contention that the disallowance of an interest deduction based on the receipt of nontaxable dividends effectively taxed such dividends in violation of the Due Process Clause, the Court of Appeal felt constrained by the determination of the California Supreme Court in *Pacific Telephone* that the "inclusion of nontaxable dividends in the statutory offset computation under section 24344 does not constitute taxation of the dividends themselves." J.A. 61. Rather than defending this position, the court below simply declared that "[w]e



defer, as we must, to that decision," even though *Pacific Telephone* was not based on constitutional considerations. J.A. 61.

In dismissing petitioner's Commerce Clause argument, the Court of Appeal again relied principally on "our Supreme Court's holding in *Pacific Telephone* that the interest offset provision does not constitute a tax on the dividends in question." J.A. 62. Hence, Commerce Clause restraints applicable to taxes were not relevant because "our high court has held the interest offset provision is not a tax on the income in question here." J.A. 65. The court found this Court's decision in *Fulton* distinguishable, even though it struck down a statute like California's which conferred a tax benefit based on the extent of a taxpayer's in-state presence, on the ground that here the "alleged favorable effect on local commerce is indirect and incidental." J.A. 62. As for the long line of cases from this Court holding facially discriminatory taxes violative of the Commerce Clause, the Court of Appeal found them "not determinative" because "[i]n the absence of a directly applicable ruling by the federal Supreme Court holding unconstitutional an interest offset provision such as the one in issue here, we remain bound by *Pacific Telephone*." J.A. 63.

**(c) The California Supreme Court.** On March 24, 1999, the California Supreme Court denied Hunt-Wesson's petition for review. J.A. 67.

## SUMMARY OF ARGUMENT

California's attempt through its interest offset provision to limit a nondomiciliary corporation's right to an otherwise available deduction for interest expense suffers from three fundamental constitutional flaws.

*First*, by denying a nondomiciliary corporation an interest expense deduction merely because it receives income that the Constitution forbids California from taxing, California effectively is taxing that income in violation of the Constitution. A State may not tax indirectly income that it may not tax directly. Yet that is the inescapable effect of the interest offset provision. By reducing an otherwise allowable interest expense deduction on a dollar-for-dollar basis by the amount of the dividend income it may not constitutionally tax, California increases a nondomiciliary corporation's tax base by the exact amount of that nontaxable income. Because the statute does not require – and the facts do not reveal – any relationship between the disallowed interest expense and the nontaxable income, the effect is simply to tax the exempt income, or, what amounts to the same thing, to subject one to greater burdens upon taxable income solely because one receives income that is tax-exempt. *National Life Ins. Co. v. United States*, 277 U.S. 508 (1928).

*Second*, by denying nondomiciliary (but not domiciliary) corporations the right to reduce their taxable income by interest expense deductions to the extent that the corporation receives dividends from nonunitary corporations, the interest offset provision discriminates against corporations domiciled outside the State. The preferential treatment persists regardless of whether the interest



expense bears any relationship to the production of the dividends in question. Because the allowance or disallowance of the deduction turns entirely on the domicile of the dividend-receiving corporation, it violates the cardinal principle of this Court's Commerce Clause jurisprudence barring taxes that facially discriminate in favor of in-state over out-of-state entities. *See, e.g., South Cent. Bell Tel. Co. v. Alabama*, 526 U.S. 160 (1999) (striking down franchise tax that favored domestic over foreign corporations).

*Third*, wholly apart from the question whether California may constitutionally deny an interest expense deduction, on a dollar-for-dollar basis, to the extent of a nondomiciliary taxpayer's nonunitary dividends, the interest offset provision is invalid for another, independent reason: It permits taxpayers receiving nonbusiness dividends to deduct their interest expense, but *only* to the extent that the dividends derive from corporations that are taxable in California. By conditioning a tax benefit (the deductibility of interest expense) on the extent of a corporation's in-state activity, the provision discriminates on its face against interstate commerce. In this respect, the interest offset provision is virtually identical to the North Carolina taxing scheme this Court struck down in *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996), where the State's intangible property tax exemption was measured by the extent of the corporation's in-state activity.

## ARGUMENT

### I. BY DENYING A DEDUCTION IN THE AMOUNT OF INCOME THAT CALIFORNIA IS PRECLUDED FROM TAXING UNDER THE COMMERCE AND DUE PROCESS CLAUSES, CALIFORNIA IS INDIRECTLY TAXING INCOME BEYOND ITS CONSTITUTIONAL REACH

It is "a just and well-settled doctrine established by this court, that a State cannot do that indirectly which she is forbidden by the constitution to do directly." *Passenger Cases*, 48 U.S. 283, 458 (1848) (plurality opinion). The Court has consistently applied this "great principle" (*id.* at 459) to invalidate state exactions that purport to tax indirectly what the Constitution forbids States from taxing directly. *See, e.g., id.* (striking down an exaction on foreign passengers as a prohibited "duty on tonnage," U.S. Const. art. I, § 10, cl. 3); *Guy v. Baltimore*, 100 U.S. 434, 443 (1880) (striking down wharfage fee on vessels carrying out-of-state products "as a mere expedient or device to accomplish, by indirection, what the State could not accomplish by a direct tax"); *Frick v. Pennsylvania*, 268 U.S. 473, 495 (1925) (striking down state estate tax on the ground that "[i]t would open the way for easily doing indirectly what is forbidden to be done directly, and would render important constitutional limitations of no avail"); *Lee v. Oscèola & Little River Rd. Improvement Dist. No. 1*, 268 U.S. 643 (1925) (striking down state tax scheme that would "accomplish indirectly the collection of a tax against the United States which could not be directly imposed").

The practical effect of California's interest offset provision is to tax indirectly income that California has no



power, under the Commerce and Due Process Clauses, to tax directly. This conclusion follows inexorably from two undisputed propositions.

*First*, the dividends that petitioner received from its nonunitary subsidiaries are not constitutionally taxable by California. The law is settled that the Commerce and Due Process Clauses bar a State from taxing dividends that a nondomiciliary corporation receives from its nonunitary subsidiaries. *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768 (1992); *ASARCO, Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307 (1982); *F.W. Woolworth Co. v. Taxation & Revenue Dep't*, 458 U.S. 354 (1982). The parties accordingly have stipulated that the "dividends received by Beatrice constituted nonunitary, nonbusiness income not subject to apportionment, or taxation, by the State of California." Stip. ¶ 8 (J.A. 19).

*Second*, the only reason why the Board disallowed Beatrice's interest expense is because petitioner received such constitutionally exempt income. Under the interest offset provision, the relationship, if any, of the disallowed interest expense to the production of the constitutionally exempt income is simply irrelevant. Accordingly, the parties again stipulated that "[t]he disallowance of Beatrice's interest expense was due *entirely* to the receipt by Beatrice of dividends from its nonunitary subsidiaries . . . . " Stip. ¶ 14 (J.A. 21) (emphasis supplied).

By denying petitioner a deduction for interest expense equal to the amount of its constitutionally exempt income, California increases petitioner's taxable income base by the precise amount of such income. Because California denies this deduction for no reason

other than petitioner's receipt of the exempt income, the conclusion is inescapable that California effectively taxes such income. This is particularly evident when, as in this case, none of that interest expense bore any direct relationship to the production of the exempt income.[14]

In short, it is plain that the increase in petitioner's taxable income is attributable "entirely" (Stip. ¶ 14 (J.A. 21)) to the receipt of income that California has no power to tax under the Commerce and Due Process Clauses. Because petitioner's California tax liability was the same as if its immune income was taxable, the practical effect of the interest offset provision is to tax petitioner's constitutionally exempt income.[15]

The court below did not – and could not – dispute the proposition that the practical effect of the interest offset provision was to tax petitioner's exempt income.[16] Instead, tracking the reasoning of the California Supreme Court opinion in *Pacific Tel. & Tel. Co. v. Franchise Tax Bd.*,

---

[14] As the trial court observed, "it appears that no portion of the interest expense deduction can be attributable to the generation of the . . . exempt dividends." J.A. 46.

[15] For example, in 1982, because Beatrice received nonbusiness dividends that California could not tax of $19,022,617, California applied the interest offset provision and increased Beatrice's taxable income subject to apportionment by that same amount. Thus, for each dollar of immune dividend income received by Beatrice, the interest offset provision increased Beatrice's taxable income subject to California apportionment by that same dollar.

[16] In fact, the Court of Appeal acknowledged the "persuasive force" (J.A. 61) of petitioner's contention that "the interest offset is overbroad, because it *fails* to apportion interest expense" (J.A. 61 (emphasis supplied)).



7 Cal. 3d 544, 498 P.2d 1020 (1972), the Court of Appeal, in substance, viewed the essential question in this case as whether the *legal* effect of the interest offset provision was the same as its *practical* effect. It held that the answer to this question is no. According to the court, the legal effect of denying a deduction was different from its practical effect on the ground that "the California Supreme Court explicitly held that inclusion of nontaxable dividends in the statutory offset computation under section 24344 does not constitute taxation of the dividends themselves." J.A. 61. Such elevation of form over substance, however, has no place in the analysis of Commerce and Due Process Clause restraints on state taxation.[17]

This Court has condemned, in general, efforts like California's to evade constitutional restrictions on the State's taxing power by circuitous means. It also has condemned specifically, in a related context, the precise mechanism that California seeks to employ here to tax the exempt income. In *National Life Ins. Co. v. United States*, 277 U.S. 508 (1928), this Court struck down a provision of the federal income tax law which permitted insurance

---

[17] The Court has made it clear in analyzing constitutional restraints on State taxes that its decisions "consider [ ] not the formal language of the tax statute but rather its practical effect," *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977); that they evaluate "state taxation based upon its actual effect rather than its legal terminology," *American Trucking Ass'ns v. Scheiner*, 483 U.S. 266, 295 (1987); that they are grounded in "economic realities," *id.*; and that they eschew "magic words or labels," *Railway Express Agency, Inc. v. Virginia*, 358 U.S. 434, 441 (1959), "avoid formalism," *Trinova Corp. v. Michigan Dep't of Treasury*, 498 U.S. 358, 373 (1991), and reflect "pragmatism." *Quill Corp. v. North Dakota*, 504 U.S. 298, 310 (1992).

companies to exclude municipal bond interest from their gross income but at the same time required the insurance companies to reduce an unrelated deduction for reserves by the full amount of the exempt interest. In other words, for each dollar of tax-exempt income the taxpayer received, it had to reduce an otherwise allowable deduction by one dollar. Treating the disallowance of the deduction for what it was – a transparent effort to tax exempt income by denying an unrelated deduction in the same amount – the Court ruled that "[o]ne may not be subjected to greater burdens upon his taxable property solely because he owns some that is free." *Id.* at 519.

The statutory provision invalidated in *National Life* is remarkably similar to the California provision at issue here. In each case, a taxpayer ordinarily is entitled to claim a deduction that reduces its income tax base; in each case the taxpayer is required to forgo the deduction, and thereby increase its taxable income, by the amount of its exempt income; and in each case, the deduction need not – and does not – bear any relationship to the exempt income in question. Consequently, the Court of Appeal's decision sustaining California's interest offset provision cannot be squared with the rationale of *National Life* – that one may not be subjected to greater burdens upon taxable income solely because one receives income that is tax-exempt.

In short, California's interest offset provision is a paradigmatic example of a State's effort to tax indirectly what it may not tax directly. By reducing an otherwise allowable interest expense deduction by the amount of dividend income it may not tax under the Commerce and



Due Process Clauses, California increases a nondomiciliary corporation's tax base by the exact amount of the exempt income. Because the statute does not require – and the facts do not reveal – any relationship between the disallowed interest expense and the nontaxable income, the effect is simply to tax the exempt income in violation of the Commerce and Due Process Clauses.

### A. The Interest Offset Provision Cannot Be Defended as an Effort to Allocate Interest Expense to Related Income

Throughout this litigation, respondent's principal defense of the interest offset provision has been that it serves to allocate interest expense to related income, *i.e.*, to the income produced by the loans on which the interest was paid. *See, e.g.*, Brief in Opposition to Petition for Writ of Certiorari ("Br. Opp."), *passim*. If respondent's view of the interest offset provision were accurate, petitioner would not be here. Petitioner takes no issue with the widely accepted principle that interest expense should be allocated to the income that it helps produce. But respondent's characterization of the interest offset rule as a method for "correlating" (*id.* at 11) or "matching" (*id.* at i) or reflecting the "economic relationship between" (*id.* at 14) interest expense and related income is demonstrably false. Once the false predicate underlying respondent's argument is removed, the defense collapses.

First, the statute itself unequivocally requires that net business interest expense must be reduced, not just by the

interest expense fairly attributable to the taxpayer's nontaxable interest and dividends, but by the full amount of those nontaxable interest and dividends.[18] This reduction of the interest expense deduction by the amount of the nonbusiness interest and dividend income is absolute and unconditional.[19] There is no "matching," no "correlation," no "economic relationship," no anything; just an arbitrary assignment, on a dollar-for-dollar basis, of business interest expense to nontaxable, nonbusiness income.[20]

Second, the premise that the interest offset is merely "matching" nonbusiness income with related interest

---

[18] As we have noted above (*see supra p. 8*), the statute permits a taxpayer a deduction for its business interest expense in the amount of its "interest income subject to allocation by formula," Cal. Rev. & Tax. Code § 24344(b), *i.e.*, apportionable or business interest income. Hence, it is the "net" business interest expense – the interest expense attributable to business income that remains after subtracting apportionable interest income – that is at issue here.

[19] The statute limits the net business interest expense deduction to the "amount, if any, by which the balance of interest expense exceeds interest and dividend income . . . not subject to allocation by formula." Cal. Rev. & Tax. Code § 24344(b).

[20] As noted above, even the Court of Appeal acknowledged the "persuasive force" (J.A. 61) of petitioner's contention that "the interest offset is overbroad, because it *fails* to apportion interest expense" (J.A. 61 (emphasis supplied)), but felt bound to follow the spurious position of the California Supreme Court in *Pacific Telephone*, which did not even address the federal constitutional issues raised by petitioner here, that the "inclusion of nontaxable dividends in the statutory offset computation . . . does not constitute taxation of the dividends themselves."



expense is further undermined by the fact that, under California law, nonbusiness interest expense has already been disallowed as a deduction, and thereby eliminated from the calculus, prior to the application of the interest offset provision. Stip. ¶ 11 (J.A. 20). It is only the remaining *business* interest expense that is subject to the interest offset rule, as the parties have stipulated. Stip. ¶¶ 11, 13 (J.A. 20). Accordingly, rather than "matching" interest expense to nonbusiness dividends, the interest offset rule *over*allocates such interest expense to such dividends by assigning business interest expense dollar-for-dollar to nonbusiness dividends.

Finally, respondent's attempt to justify the interest offset provision on the ground that "money . . . is fungible" (Br. Opp. at 12) and that "interest costs cannot be readily traced to the specific classification of income which is generated from both business and nonbusiness activities" (*id.*) is a classic nonsequitur. Even if money is fungible, it does not follow that California may adopt any provision – no matter how arbitrary – to allocate interest expense between taxable and nontaxable income. In fact, the interest offset provision does not even rise to the level of an arbitrary allocation provision, because, rather than allocating interest expense between taxable and nontaxable income, it simply assigns it, on a dollar-for-dollar basis, to nontaxable income.

Most tellingly of all, respondent's claim that it is "difficult" as a practical matter to determine "the extent to which interest expense is attributable to business income as opposed to nonbusiness income" (*id.*) is belied by California's own statutes and regulations requiring just such an allocation; by statutes and regulations in

other States providing for such an allocation and, in many instances, prescribing methods of fairly attributing interest expense to different classes of income even when the expenses are not traceable to a particular item or items of income; and, by the U.S. Treasury's adoption of similar interest allocation provisions for federal income tax purposes. We briefly describe these interest allocation provisions below.

### 1. California Itself Has Adopted Statutory and Regulatory Provisions That Seek to Allocate Interest Expense to Related Income in a Fair Manner

Despite the Board's remonstrations about the difficulty of fairly allocating interest expense to related income in light of the fungibility of money, and its invocation of those difficulties as a justification for the interest offset provision's blanket assignment of *all* business interest expense (in excess of business interest income) to nonbusiness income (Br. Opp. 12), California's statutes and regulations in fact provide for precisely the type of reasonable allocation of interest and other expenses to related income that would obviate the constitutional issues raised by this case. For example, section 24425 of the Cal. Rev. & Tax. Code precludes a deduction for "[a]ny amount otherwise allowable as a deduction which is allocable to . . . income not included in the measure of the tax." The California State Board of Equalization ("SBE") has interpreted that provision as incorporating direct tracing. Thus, if the proceeds of a loan can be directly traced to a specific business or non-business purpose, the interest expense is assigned accordingly. *See*



*Appeal of Zenith Nat'l Ins. Corp.*, 1998 Cal. Tax LEXIS 1, 4 Cal. St. Tax Rep. (CCH) ¶ 402-965 (SBE Jan. 8, 1998), *modified*, 1998 Cal. Tax LEXIS 651, 4 Cal. St. Tax Rep. (CCH) ¶ 403-048 (SBE June 25, 1998) (a copy of these decisions are reproduced in the Appendix at App. 23a).

Moreover, even when interest expense cannot be specifically identified with any particular class of income, California has shown itself quite capable of devising reasonable methods for fairly allocating interest expense between various classes of income rather than arbitrarily offsetting such expense on a dollar-for-dollar basis against nontaxable income. Thus, the SBE has upheld the Board's denial of interest expenses allocated to nontaxable income using the ratio of nontaxable income to taxable income. *Appeal of Zenith Nat'l Ins. Corp., supra.*[21]

---

[21] Similarly, under subsection (c) of section 24344 (enacted after the years in issue), the California regulations attributing interest expense to foreign investment recognize that, in some circumstances, interest expense may be "related solely to specific property." Cal. Code Regs. tit. 18, § 24344(c)(4)(A). In other circumstances, where "it is difficult if not impossible to specifically assign the cost of funds to specific activities," Cal. Code Regs. tit. 18, § 24344(c)(1), California allocates the otherwise unassigned interest expense according to "the ratio of the value of foreign investment to the total value of all assets . . . . " Cal. Code Regs. tit. 18, § 24344(c)(5)(B)(i). The regulations further provide the following example of the allocation methodology with respect to interest expense that is not related to specific property or activities:

> Corporation A has total interest expense of $1,100. Specifically assigned interest expense is $100. A has foreign investments valued at $500 and total assets valued at $5,500. Specifically assigned interest expense relates to total assets of $500, none of which is foreign investment. . . .

Thus, it is plain that California does not always throw up its institutional hands – as it does in the interest offset provision – and arbitrarily assign the interest expense on a dollar-for-dollar basis to exempt income.

**2. Other States Have Adopted Statutory and Regulatory Provisions That Seek to Allocate Interest Expense to Related Income in a Fair Manner**

As revealed in more detail in the Appendix to this brief, most States with an income tax have adopted statutes or regulations providing for a fair allocation of interest expense to related income; many have prescribed methods of fairly attributing interest expense to different classes of income when the expenses are not clearly related to a particular item or class of income; and none has embraced a "methodology" like California's, which simply assigns interest expense, on a dollar-for-dollar basis, to nontaxable income.[22] For example:

---

The amount of unassigned interest expense attributable to foreign investment is calculated as follows: Total Interest Expense – Assigned Interest Expense = Unassigned Interest Expense ($1,100 – $100 = $1,000). Unassigned Interest Expense x value foreign investment/value total assets (Assets without specifically assigned interest) = interest expense assignable to foreign ($1,000 x $500/$5,000 = $100).

Cal. Code Regs. tit. 18, § 24344(c)(5)(B)(iii).

[22] While there may be interpretations or administrative practices not apparent on the face of the state statutes and regulations that we reviewed, our research disclosed only two States (Idaho and Wisconsin) that ever had an interest offset provision anything like California's, and neither of those States has such a provision in effect today.



- Alabama prorates interest expense deductions between business and nonbusiness income by multiplying total interest expense by the ratio of the average cost of nonbusiness assets to the average cost of total assets;[23]
- the District of Columbia reduces a corporation's deductible interest expense according to the ratio of the average value of the assets producing nontaxable income to the average value of the corporation's total assets;[24]
- Hawaii provides for the proration of deductions among items of business and nonbusiness income in a manner that fairly distributes the deduction among the classes of income to which it is applicable, and, when deductions are not connected with particular classes of income, it provides for an allocation based on the ratio of Hawaii gross income to gross income from all sources;[25]
- Kentucky provides that deductions allowed under the Internal Revenue Code be reduced by expenses allocable to nontaxable income, and it prescribes a number of methods for allocating interest and other expenses to nontaxable income (including asset- and income-based ratios);[26]
- Louisiana, Mississippi, Nebraska, New York, North Carolina, Oklahoma, and Utah have

---

[23] Ala. Code § 40-18-35(a)(2). *See* App. 1a.

[24] D.C. Reg. § 123.4. *See* App. 4a.

[25] Hawaii Reg. § 18-235-5-03(b)(4). *See* App. 6a.

[26] Ky. Rev. Stat. Ann. § 141.010(13)(d); Ky. Admin. Release, Revenue Policy 41P150 (June 1, 1983). *See* App. 9a.

adopted similar mechanisms for allocating interest expense between taxable and nontaxable income, when the interest income cannot readily be traced to any particular item or activity;[27] and

- Other States (including Alaska, Arizona, Colorado, Kansas, Missouri, North Dakota, and Oregon) have adopted the Multistate Tax Commission regulations which provide for the proration of deductions among items of business and nonbusiness income in a manner that fairly distributes the deduction among the classes of income to which it is applicable.[28]

The States' widespread adoption of a variety of methods, reasonable on their face, for attributing interest expense to the income it produces, even in circumstances when the expenses cannot be traced directly to particular classes of income, underscores the anomalous character of California's interest offset rule, as well as its indefensibility.

### 3. The Federal Government Likewise Has Adopted Rules That Seek to Allocate Interest Expense to Related Income in a Fair Manner

The Federal Government's adoption of provisions for allocating interest expense to related income, which are analogous to the provisions adopted by many of the

---

[27] *See* App. *passim.*

[28] *See* App. *passim.*



States, reinforces the conclusion that California has available to it a wide variety of reasonable alternatives to the interest offset provision for matching interest expense to interest income. For example, Section 265 of the Internal Revenue Code disallows a deduction for interest on indebtedness incurred to "purchase or carry" tax-exempt obligations. I.R.C. § 265. In prescribing the methods for allocating interest expense to the exempt obligations, the Internal Revenue Service will disallow any interest that is "directly traceable" to the holding of tax-exempt obligations and, where interest cannot be so traced:

> [t]he amount of interest on such indebtedness to be disallowed shall be determined by multiplying the total interest on such indebtedness by a fraction, the numerator of which is the average amount during the taxable year of the taxpayer's tax-exempt obligations . . . and the denominator of which is the average amount during the taxable year of the taxpayer's total assets . . . .

Rev. Proc. 72-18, 1972-1 C.B. 740; *see also* Treas. Reg. § 1.265-1(c).[29]

Similarly, in determining the appropriate allocation of interest expense to domestic and foreign source income, the federal income tax regulations provide for the apportionment of interest expense to various income-producing activities by an asset ratio and by a gross income ratio. Treas. Reg. § 1.861-9T. These regulations proceed on the premise that "money is fungible and that

---

[29] California itself has adopted this methodology under Section 24425. *See, e.g., Appeal of Zenith Nat'l Ins. Co., supra.*

interest expense is attributable to all activities and property regardless of any specific purpose for incurring an obligation on which interest is paid." Treas. Reg. § 1.861-9T(a). Ironically, respondent relied on these regulations in the proceedings below, defending the interest offset provision as reflecting the same "recognition of the fungible nature of money" as underlies the regulations. Defendant's Franchise Tax Board's Trial Brief (CT p. 178). What respondent utterly failed to appreciate, however, is that the very regulations on which it relied provide for a rational asset-based or income-based allocation of interest to various classes of income, Treas. Reg. §§ 1.861-9T(g), (j), not the wholesale assignment of interest expense to exempt income embodied in the interest offset provision.

* * *

In sum, California's interest offset provision is a deeply flawed and virtually unique approach to the problem of allocating interest expense to related income. It offends bedrock constitutional norms – not to mention common sense – by sweeping nonunitary dividends into the tax base under the guise of denying a deduction, on a dollar-for-dollar basis, for interest expense without regard to the relationship of the interest expense to the interest income. The claim that this anomalous provision is somehow justified because "money, by its very nature, is fungible" (Br. Opp. 12) does not survive scrutiny. The widespread adoption by other States, by the Federal Government, and by California itself of methods designed to allocate fairly interest expense to related income, even in circumstances when the expense cannot be traced to particular income-producing activity, demonstrates that



there are reasonable, and presumptively constitutional, alternatives to the interest offset provision.

## II. BY PROVIDING LESS FAVORABLE INTEREST EXPENSE DEDUCTIONS FOR NONDOMICILIARY CORPORATIONS THAN FOR DOMICILIARY CORPORATIONS, CALIFORNIA'S INTEREST OFFSET RULE DISCRIMINATES AGAINST INTERSTATE COMMERCE

At the same time that the interest offset provision permits California to tax nonunitary income that lies beyond its constitutional reach, it creates a second constitutional difficulty of equal concern: It discriminates against nondomiciliary corporations in favor of domiciliary corporations.

To appreciate the nature of this discrimination, one must first understand how California taxes nonbusiness dividends earned by domiciliary and nondomiciliary corporations. Under California's rules for allocation of nonbusiness income, "dividends are allocable to this state if the taxpayer's commercial domicile is in this state." Cal. Rev. & Tax. Code § 25126. Consequently, all of a domiciliary's nonbusiness dividends are allocable to – and taxable by – California. By the same token, none of a nondomiciliary's nonbusiness dividends are allocable to – or taxable by – any State in which it is not domiciled. *See* Stip. ¶ 8 (J.A. 19).

As discussed above, the interest offset provision requires taxpayers to offset their net business interest expense by the amount of their nonunitary, nonbusiness dividends. For a nondomiciliary taxpayer like petitioner,

this requirement deprives it of the benefit of an interest expense deduction for California tax purposes. It does so by arbitrarily assigning the interest expense to nonbusiness dividends – income that, as we have just explained, California does not tax when earned by nondomiciliaries. *See* Cal. Rev. & Tax. Code §§ 25123, 25126. The provision thereby reduces the nondomiciliary's *nontaxable* income and leaves its California taxable income intact.

But the opposite is true for a domiciliary corporation, which enjoys the full benefit of an interest expense deduction for California tax purposes. By assigning the domiciliary corporation's net business interest expense to nonbusiness income – income that California fully taxes when earned by domiciliaries, *see* Cal. Rev. & Tax. Code §§ 25123, 25126 – the interest offset provision reduces the domiciliary taxpayer's *taxable* California income.

At first blush, one might view this claim of discrimination as nothing more than a description of the natural consequences of allowing an interest expense deduction that corresponds to the State's power to tax nondomiciliary and domiciliary taxpayers' income. Since California has no power to tax any of the nondomiciliary taxpayer's nonbusiness dividends, California's disallowance of the expense deduction corresponds simply to its lack of power to tax the dividends, not to the taxpayer's nondomiciliary status. By the same token, since California has the power to tax all the domiciliary taxpayer's nonbusiness dividends, California's allowance of the interest expense deduction corresponds simply to its power to tax the dividends, not to the taxpayer's domiciliary status.



The critical flaw in this analysis, however, is that it is based on the false premise that there is some relationship between the nonbusiness dividend income and the expenses that are being assigned to it. If there is no relationship between the nonbusiness dividends and the interest expenses, then the denial or grant of a deduction for the interest expenses cannot be justified by reference to the State's power to tax the nonbusiness dividends. Rather, the denial or grant depends solely on the taxpayer's domicile.

Consider, for example, two corporations D and ND, identical in every respect except that D is a domiciliary of California and ND is a nondomiciliary. Assume both corporations manufacture and sell widgets in California and in other States. Each has $1,000 of apportionable business income from its widget operations, $200 of interest expense on a loan whose proceeds were used to purchase widget manufacturing machinery, and $200 of dividends from a nonunitary subsidiary producing Hula Hoops in Outer Mongolia. Under the interest offset provision, D will be able to deduct the full $200 of interest expense from its California tax base, but ND will be able to deduct nothing. Because the interest offset provision in effect transforms business interest expense into nonbusiness interest expense, it permits D to enjoy (albeit under false pretenses) a deduction against its otherwise taxable nonbusiness dividend while providing ND with a meaningless deduction against the nonbusiness dividend that California cannot tax anyway. Because it is irrelevant under the interest offset provision whether the disallowed interest expense bears any relationship to the production of the income against which the expense is offset, it is apparent that the allowance or disallowance of the

deduction turns entirely on the domicile of the dividend-receiving corporation.[30]

California's discrimination against nondomiciliary corporations in favor of domiciliary corporations patently violates established Commerce Clause criteria. The rule prohibiting taxes that discriminate against interstate commerce has been a central tenet of this Court's Commerce Clause doctrine from the very beginning. *See, e.g., Welton v. Missouri*, 91 U.S. 275 (1876); *Cook v. Pennsylvania*, 97 U.S. 566 (1878). No aspect of this doctrine is more firmly entrenched than the principle that a State may not favor in-state over out-of-state entities. *See, e.g., Robbins v. Shelby County Taxing Dist.*, 120 U.S. 489 (1887); *Nippert v. City of Richmond*, 327 U.S. 416 (1946). This Court has repeatedly condemned taxes that "favor[ ] domestic corporations over their foreign competitors." *Fulton Corp. v. Faulkner*, 516 U.S. 325, 333 (1996).

Just last Term, the Court applied these principles in striking down Alabama's franchise tax in *South Cent. Bell Tel. Co. v. Alabama*, 119 S. Ct. 1180 (1999). Alabama's

[30] Even the California Supreme Court has acknowledged that the interest offset provision affords a more favorable interest expense deduction to California domiciliaries than to those domiciled elsewhere. Table II and Table IV and the related discussion in the *Pacific Telephone* decision show that two identical corporations, except one is domiciled in California and one is domiciled outside California, are granted different interest expense deductions in California. 7 Cal. 3d at 551, 553. Under the interest offset, the California corporation is allowed a full $2 interest expense deduction, *id.* at 551 (Table II), whereas the non-California corporation is allowed no deduction for any of its interest expense. *Id.* at 553 (Table IV).



taxing scheme favored domestic over foreign corporations by giving domestic – but not foreign – corporations the ability to reduce their franchise tax liability by reducing the par value of their stock. *Id.* at 1185-86. Observing that the tax "facially discriminates against interstate commerce," a unanimous Court invalidated the tax in short order.

California's preference for its own domiciliary corporations is no different in substance from Alabama's domestic preference legislation condemned in *South Central Bell*. As in *South Central Bell*, there can be no dispute that the taxing scheme in question treats local corporations more favorably than their out-of-state competitors:[31] When domiciliary corporations receive dividends from nonunitary corporations, they receive the full benefit of an interest expense deduction against taxable income. Nondomiciliary corporations, by contrast, must forgo the benefit of the interest expense deduction to the extent of their nonunitary dividends. The preferential treatment persists regardless of whether the interest expense bears any relationship to the production of the dividends in question. Since the allowance or disallowance of the deduction turns entirely on the domicile of the dividend-receiving corporation, it violates the "virtually *per se* rule of invalidity" that this Court applies to facially discriminatory taxes. *See, e.g., Camps Newfound/Owatonna Inc. v. Town of Harrison*, 520 U.S. 564, 596 (1997).

[31] Indeed, respondent has acknowledged that the interest offset provision operates to "increase taxes on foreign corporations while reducing those of domestic corporations." *Pacific Telephone*, 7 Cal. 3d at 554.

## III. CALIFORNIA'S DENIAL OF A DEDUCTION TO THE EXTENT THAT A TAXPAYER'S SUBSIDIARY "PARTICIPATES IN INTERSTATE COMMERCE" IS INDISTINGUISHABLE FROM THE STATE TAXING SCHEME CONDEMNED IN *FULTON CORP. V. FAULKNER*, 516 U.S. 325, 333 (1996), AND PROVIDES A WHOLLY INDEPENDENT BASIS FOR INVALIDATING THE INTEREST OFFSET PROVISION

Even if this Court were to find that California is constitutionally entitled to deny petitioner an interest expense deduction to the extent of its nonunitary dividends, the interest offset provision still fails to satisfy constitutional strictures for another, wholly independent, reason: It permits nondomiciliary taxpayers receiving nonbusiness dividends to deduct their interest expense, but *only* to the extent that the dividends derive from corporations that are taxable in California. The interest offset provision therefore offends the Commerce Clause principle that state taxing schemes may not favor in-state over out-of-state investment, *see, e.g., Westinghouse Elec. Corp. v. Tully*, 466 U.S. 388 (1984); *Maryland v. Louisiana*, 451 U.S. 725 (1981), and is virtually indistinguishable from the North Carolina tax regime the Court invalidated in *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996).

Under the interest offset provision, a taxpayer must reduce its otherwise deductible interest expense by dividends received from nonunitary corporations "except dividends deductible under the provisions of Section 24402." Cal. Rev. & Tax. Code § 24344(b). Dividends deductible under Cal. Rev. & Tax. Code § 24402 are dividends "declared from income which has been included in



the measure of" California's franchise tax. Accordingly, the exception to the required reduction of deductible interest expense – and the consequent increase in California taxable income – is correlated to the proportion of the taxpayer's dividend-paying subsidiaries' business that is conducted in California. This Court struck down a strikingly similar taxing scheme in *Fulton*.

In *Fulton*, the Court considered a North Carolina intangible property tax as applied to taxpayers who owned corporate stock. The tax was imposed at the rate of 0.25 percent of the fair market value of the stock. The value of the stock assessed under the tax, however, was reduced by a percentage equal to the percentage of the corporation's income subject to tax in North Carolina. Under this regime, if the stock was issued by a corporation doing all of its business in North Carolina, a 100 percent reduction of the value of the stock would be allowed; if the stock was issued by a corporation doing 50 percent of its business in North Carolina, a 50 percent reduction of the value of the stock would be allowed; and if the stock was issued by a corporation doing none of its business in North Carolina, no reduction of the value of the stock would be allowed.

The Court had no hesitation in branding North Carolina's taxing scheme as "facially" discriminatory (*id.* at 333):

> A regime that taxes stock only to the degree that its issuing corporation participates in interstate commerce favors domestic corporations over their foreign competitors in raising capital among North Carolina residents and tends, at

> least, to discourage domestic corporations from plying their trades in interstate commerce.

*Id.*

California's interest offset scheme suffers from precisely the same constitutional infirmity. It permits a nondomiciliary taxpayer an interest deduction against taxable income (and thus a reduction in California tax) only to the extent that a nonunitary, dividend-paying subsidiary does business in California. Thus, just as in North Carolina, the taxpayer receives a benefit only insofar as the corporation in which it has invested is doing business in the taxing State. If the taxpayer's nonunitary, dividend-paying subsidiary were doing all of its business in California, a 100 percent deduction of the taxpayer's otherwise deductible interest expense would be allowed; if the taxpayer's nonunitary, dividend-paying subsidiary were doing 50 percent of its business in California, 50 percent of the taxpayer's otherwise deductible interest expense would be allowed; and if the taxpayer's nonunitary, dividend-paying subsidiary were doing none of its business in California, none of the taxpayer's otherwise deductible interest expense would be allowed.

The Court's conclusion with regard to the North Carolina regime applies equally to the California regime:

> A regime that [denies an interest deduction] only to the degree that [the dividend-paying subsidiary] participates in interstate commerce favors domestic corporations over their foreign competitors in raising capital among [California] residents and tends, at least, to discourage domestic corporations from plying their trades in interstate commerce.



*Fulton*, 516 U.S. at 333. Accordingly, Cal. Rev. & Tax. Code § 24344(b) "facially discriminates against interstate commerce." *Id.*

Little more needs to be said after *Fulton* about the unconstitutionality of California's discrimination in favor of taxpayers who invest in corporations that conduct their activity in California rather than in other States. Nevertheless, it is plain that the provision is wholly irreconcilable with the bedrock principle of this Court's Commerce Clause jurisprudence that "a State may not tax a transaction or incident more heavily when it crosses state lines than when it occurs entirely within the State." *Armco, Inc. v. Hardesty*, 467 U.S. 638, 642 (1984). California's interest offset provision fails to satisfy this criterion.

Consider the choice facing a nondomiciliary corporation like petitioner, which is taxable in California and is considering whether to invest in nonunitary Corporation A, which does business only in California, or in nonunitary Corporation B, which does business only in other States. If petitioner invests in Corporation A, it will receive a deduction for its net interest expense to the extent of the dividends paid by Corporation A. If it invests in Corporation B, it will be denied a deduction for its net interest expense to the extent of the dividends paid by Corporation B.

A more blatant violation of the Court's Commerce Clause doctrine is difficult to imagine. A nondomiciliary corporation which invests in a subsidiary engaged in activity in other States is penalized by comparison to its competitor which invests in a subsidiary that plies its

trade within the taxing State. The price of investing outside California is the loss of an interest expense deduction. California's taxing scheme therefore "forecloses tax-neutral decisions" (*Boston Stock Exch. v. State Tax Comm'n*, 429 U.S. 318, 331 (1977)) and has a forbidden impact on interstate commerce because "it exerts an inexorable hydraulic pressure on interstate businesses to ply their trade within the State that enacted the measure rather than 'among the several States.'" *American Trucking Ass'ns v. Scheiner*, 483 U.S. 266, 286-87 (1987).[32]

[32] We wish to reiterate that the constitutional difficulties engendered by the limitation of the interest expense deduction to dividends received from corporations doing business in California exist entirely aside from the constitutional infirmities we have addressed in Points I and II above. *See supra 18 and 33.* Even if the general disallowance of interest expense due to the receipt of tax-exempt dividends were sustained, California still would be precluded from selectively allowing an interest expense deduction based on the extent of the in-state presence of the taxpayer's dividend-paying subsidiaries. Indeed, even if there were no interest offset provision at all, and California simply denied any deduction for interest expense, except to the extent that one received dividends from corporations paying tax in California, the limitation would fail to pass constitutional muster for the reasons set forth above. In short, the denial to petitioner of an interest expense deduction to the extent that its dividend-paying subsidiaries did not derive their income from California is fatally defective, wholly apart from the interest offset provision's other constitutional deficiencies.



## CONCLUSION

For the foregoing reasons, the judgment of the California Court of Appeal should be reversed.

Respectfully submitted,

Drew S. Days III
127 Wall Street
New Haven, CT 06520
(203) 432-4948

Walter Hellerstein
University of Georgia Law School
Herty Drive
Athens, GA 30602
(706) 542-5175

Charles J. Moll III
(*Counsel of Record*)
Edwin P. Antolin
Morrison & Foerster LLP
425 Market Street
San Francisco, CA 94105
(415) 268-6497

Fred O. Marcus
Horwood, Marcus & Berk, Chartered
333 West Wacker Drive, Suite 2800
Chicago, IL 60606
(312) 606-3210

*Counsel for Petitioner*

## APPENDIX

### STATE-BY-STATE TREATMENT OF INTEREST EXPENSE ALLOCATION

| STATE | STATUTE OR REGULATION | PERTINENT LANGUAGE |
|---|---|---|
| Alabama | Ala. Code § 40-18-35(a)(2) | "All interest paid or accrued within the taxable year on its indebtedness as determined in accordance with 26 U.S.C. Sections 163, 264, and 265. In the case of a corporation not commercially domiciled in Alabama, the amount of interest otherwise deductible under this subdivision shall be reduced by the amount that bears the same ratio to the total interest expense as the average value of the corporation's assets producing nonbusiness income bears to the average value of the corporation's total assets . . . " |

| | | |
|---|---|---|
| Alaska | Alaska Reg., 15 AAC 20.620 | "Expenses incurred in acquiring, maintaining, and disposing of tax-exempt assets, including interest expense, may not be deducted in computing taxable income." |
| | Alaska Reg., 15 AAC 19.041 | " . . . the deduction shall be prorated among those trades or businesses and those items of nonbusiness income in a manner which fairly distributes the deduction among the classes of income to which it is applicable." |
| Arizona | Ariz. Rev. Stat. § 43-961(5) | Deduction not allowed for: "Any amount, not otherwise provided for by this section, that would otherwise be allowable as a deduction or an adjustment, which is allocable to one or more classes of income, whether or not any amount of income of that class or classes is received or accrued, and that is not required to be included in a person's Arizona adjusted gross |



| | | |
|---|---|---|
| | | income or Arizona taxable income." |
| | Ariz. Reg., R15-2-1131(C) | " . . . deduction shall be prorated among such trades or businesses and such items of nonbusiness income in a manner which fairly distributes the deduction among the classes of income to which it is applicable." |
| Arkansas | Ark. Code Ann. § 26-51-431(c) | "For the purpose of computing Arkansas corporation income tax liability, no deduction shall be allowed for:<br>. . .<br>(2) Interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from the taxes imposed by Arkansas law . . . . " |
| California | Cal. Rev. & Tax. Code § 24344(a) | "Section 163 of the Internal Revenue Code relating to interest, shall apply, except as otherwise provided." |
| | Cal. Rev. & Tax. Code § 24344(b) | Interest offset provision. |

| | | |
|---|---|---|
| Colorado | Colo. Reg. IV.1(d)(1) | " . . . deduction shall be prorated among such trades or businesses and such items of nonbusiness income in a manner which fairly distributes the deduction among the classes of income to which it is applicable." |
| Delaware | Del. Code, tit. 30, § 1903(b)(5) | "Interest (including discount) to the extent included in determining entire net income under subsection (a) of this section, less related or applicable expenses, shall be allocated to the state where the transaction took place which resulted in the creation of the obligation with respect to which the interest was earned." |
| District of Columbia | D.C. Reg., § 123.4 | " . . . interest expenses of a corporation, financial institution, or unincorporated business shall be reduced by the amount that the ratio of the average value of the assets producing nontaxable income |



| | | |
|---|---|---|
| | | bears to the average value of the total assets of the corporation, financial institution or unincorporated business." |
| Florida | Fla. Stat. ch. 220.03(1)(r) | " . . . 'income' means gross receipts less all expenses directly or indirectly attributable thereto." |
| Georgia | Ga. Reg., § 560-7-7-.03 (3) | " . . . All expense connected with earning such investment income, such as interest on money borrowed to pay for such property, . . . shall be deducted from the gross investment income. The net investment income is not subject to apportionment." |
| Hawaii | Haw. Rev. Stat. § 235-7(e) | "There shall be disallowed as a deduction the amount of interest paid or accrued within the taxable year on indebtedness incurred or continued, (1) to purchase or carry bonds the interest upon which is excluded from gross |

| | | |
|---|---|---|
| | | income . . . ; or (2) to purchase or carry property owned without the State, or to carry on trade or business without the State, if the taxpayer is a person taxable only upon income from sources in the State." |
| | Hawaii Reg. § 18-235-5-03(b)(4) | "Deductions from Hawaii adjusted gross income that are not connected with particular property or income, such as medical expenses, shall be allowed only to the extent of the ratio of Hawaii adjusted gross income to adjusted gross income from all sources." |
| Idaho | Idaho Code § 63-3027(d) | "In the case of allocable nonbusiness interest or dividends, related expenses include interest on indebtedness incurred or continued to purchase or carry assets on which the interest or dividends are nonbusiness income." |



| | | |
|---|---|---|
| Illinois | 35 Ill. Comp. Stat. 5/303(a) | "Any item of capital gain or loss, and any item of income from rents or royalties from real or tangible personal property, interest, dividends, and patent or copyright royalties, and prizes awarded under the Illinois Lottery Law, to the extent such item constitutes nonbusiness income, together with any item of deduction directly allocable thereto, shall be allocated by any person other than a resident as provided in this Section." |
| Indiana | Ind. Reg., Rule 45 IAC 3.1-1-56 | "Rents, royalties, capital gains, interest and dividends when considered nonbusiness income are allocated to specific jurisdictions as outlined in Regulations 6-3-2-2(h) through 6-3-2-2(k) [45 IAC 3.1-1-57 – 45 IAC 3.1-1-61]. Such income and the deductions connected therewith are not taken into |

| | | |
|---|---|---|
| | | consideration in computing the taxpayer's apportionment formula. When the taxpayer has deductions applicable to both business and nonbusiness income, such deductions must be prorated to determine what part is subject to allocation." |
| Iowa | Iowa Reg., Rule 701 – 54.3(422) | " . . . Related expenses shall mean those expenses directly related, including related federal income taxes . . . . A directly related expense shall mean an expense which can be specifically attributed to an item of income . . . ." |
| Kansas | Kan. Stat. Ann. § 79-3274 | " . . . Allocable nonbusiness income shall be limited to the total nonbusiness income received which is in excess of any related expenses which have been allowed as a deduction during the income year." |
| | Kan. Reg., § 92-12-74 | " . . . deduction shall be prorated among such trades or businesses and such items |



| | | |
|---|---|---|
| | | of nonbusiness income in a manner which fairly distributes the deduction among the classes of income to which it is applicable." |
| Kentucky | Ky. Rev. Stat. Ann. § 141.010(13)(d) | No deduction for "[a]ny deduction directly or indirectly allocable to income which is either exempt from taxation or otherwise not taxed . . . ." |
| | Ky. Admin. Release, Revenue Policy 41P150 (June 1, 1983) | "If actual expenses, such as interest, salaries, general and administrative and other stewardship expenses, cannot be related directly to such income, a formula must be used." |
| Louisiana | La. Reg., § 1130(B)(1) | "The amount of interest which is applicable to such investments shall be determined by multiplying the total amount of interest expense by a ratio, the numerator of which is the average value of investments which produce or which are held for the |

| | | |
|---|---|---|
| | | production of allocable income, and the denominator of which is the average value of all assets of the taxpayer." |
| Maine | Me. Reg., Rule No. 801(.03) | "Any allowable deduction that is applicable both to business and nonbusiness income or to more than one trade or business of the taxpayer shall be prorated to those classes of income or trades or businesses in determining income subject to tax." |
| Maryland | No provision | |
| Massachusetts | Mass. Gen. Laws ch. 63, § 30.4 | " . . . any deduction otherwise allowable which is allocable, in whole or in part, to one or more classes of income not included in a corporation's taxable net income, as determined under subsection (a) of section thirty-eight, shall not be allowed." |
| Michigan | No corporate income tax | |



| | | |
|---|---|---|
| Minnesota | Minn. Stat. § 290.10 | " . . . in computing the net income of a taxpayer no deduction shall in any case be allowed for expenses, interest and taxes connected with or allocable against the production or receipt of all income not included in the measure of the tax imposed by this chapter . . . . " |
| | Minn. Stat. § 290.17(1)(b) | "Expenses, losses, and other deductions . . . must be allocated along with the item or class of gross income to which they are definitely related for purposes of assignment . . . . Deductions not definitely related to any item or class of gross income are assigned to the taxpayer's domicile." |
| Mississippi | Miss. Code § 27-7-23(c)(4)(H) | "Nonbusiness interest expense shall be computed by using the ratio of nonbusiness assets to total assets applied to total interest expense." |

| | | |
|---|---|---|
| Missouri | Mo. Reg., 12 CSR 10-2.075(6) | " . . . the deduction shall be prorated among the trades or businesses and the items of nonbusiness income in a manner which fairly distributes the deduction among the classes of income to which it is applicable." |
| Montana | Mont. Code Ann. § 15-31-114(1)(d) | "Interest may not be allowed as a deduction if paid on an indebtedness created for the purchase, maintenance, or improvement of property or for the conduct of business unless the income from the property or business would be taxable under this part." |
| Nebraska | Neb. Rev. Stat. § 77-2734.06(3) | "The interest expense for the reduction required . . . shall be determined by dividing the taxpayer's average investment in the activities producing the income by the taxpayer's average total assets and multiplying such ratio by |



| | | |
|---|---|---|
| | | the total interest deduction allowed in the computation of federal taxable income." |
| Nevada | No corporate income tax | |
| New Hampshire | N.H. Rev. Stat. Ann. § 77-A:4(X) | "In the case of a business organization which excludes any portion of its gross business profits pursuant to federal constitutional law, an addition to gross business profits for the amount of any deducted expenses related to such excluded portion." |
| New Jersey | N.J. Rev. Stat. § 54:10A-6.1(b) | "Corporate expenses related to nonoperational income are not deductible in determining entire net income." |
| New Mexico | N.M. Admin. Code tit. 3 § 5.5.8 | "From the items of gross income from rents, patent and copyright royalties, interest, dividends and capital gains being specifically allocated to or outside this state, there shall be deducted the |

| | | |
|---|---|---|
| | | expenses related thereto. The term 'expenses related thereto' as used in this section (3 NMAC 5.5.8) means the expenses and other deductions directly attributable to such rents, patent and copyright royalties, interest, dividends and capital gains and a ratable part of any other expenses or deductions which cannot definitely be allocated to some item or class of income." |
| New York | N.Y. Tax Law, Ch. 60, § 208.9(b)(6) | "Entire net income shall be determined without the exclusion, deduction or credit of: . . .<br><br>In the discretion of the tax commission, any amount of interest directly or indirectly . . . attributable as a carrying charge or otherwise to subsidiary capital or to income, gains or losses from subsidiary capital." |



| | | |
|---|---|---|
| | N.Y. Tax Law, Ch. 60, § 208.6 | "The term 'investment income' means the sum of (a) income, . . . less, (c) in the discretion of the commissioner, any deductions allowable in computing entire net income which are directly or indirectly attributable to investment capital or investment income . . . ." |
| North Carolina | N.C. Regulation, Rule, § 17:05C.0304, subds. b and c | " . . . shall attribute a portion of the interest expense to such untaxed income and property in determining taxable income reported to this State. The formula used for computing the amount of interest expense to be attributed to untaxed income and property is as follows . . . ." |
| North Dakota | N.D. Reg., § 81-03-09-06 | " . . . deduction shall be prorated among such trades or businesses and such items of nonbusiness income in a manner which fairly distributes the deduction among the |

| | | |
|---|---|---|
| | | classes of income to which it is applicable." |
| Ohio | Ohio Rev. Code § 5733.04(I)(2) | "For purposes of determining net foreign source income deductible under division (I)(2) of this section, the amount of gross income from all such sources other than income derived by application of section 78 or 951 of the Internal Revenue Code shall be reduced by: . . .<br><br>(c) Fifteen per cent of the amount of dividends and all other income.<br><br>The amounts described in divisions (I)(2)(a) to (c) of this section are deemed to be the expenses attributable to the production of deductible foreign source income unless the taxpayer shows, by clear and convincing evidence, less actual expenses, or the tax commissioner shows, |



| | | |
|---|---|---|
| | | by clear and convincing evidence, more actual expenses." |
| Oklahoma | Okla. Stat. tit. 68 § 2358(A)(4) | "Allowable deductions attributable to items separately allocable . . . , whether or not such items of income were actually received, shall be allocated on the same basis as those items . . . . " |
| | Okla. Rule 710:50-17-51(6) | "The expense adjustment is used to more clearly reflect true income. The manner in which this adjustment is made is as follows: A fraction, or percentage, is computed by dividing the average of investment in assets, the income from which is nontaxable, by the average of total assets. This result is then applied to certain expenses claimed on the return. Generally, interest expense is the only expense against which this result is applied. However, facts and circumstances may |

| | | |
|---|---|---|
| | | indicate that other expenses should be considered in this allocation. This adjustment will be considered in all cases where deemed appropriate." |
| Oregon | Or. Admin. R., § 150-314.610 (1)-(C) | " . . . deduction shall be prorated among such trades or businesses and such items of nonbusiness income in a manner which fairly distributes the deduction among the classes of income to which it is applicable." |
| Pennsylvania | 72 Pa. Cons. Stat. § 7401 (3)(b.1) | "An additional deduction shall be allowed from taxable income in the amount of any interest income from securities issued by the United States or agencies or instrumentalities thereof, to the extent included in Federal taxable income but exempt from the tax imposed by this article under the laws of the United States, but reduced by any |



| | | |
|---|---|---|
| | | interest on indebtedness incurred to carry the securities, any expenses incurred in the production of such interest income and any other expenses deducted on the federal income tax return that would not have been allowed under Section 265 of the Internal Revenue Code . . . if the interest were exempt from Federal income tax." |
| Rhode Island | No provision | |
| South Carolina | 27 S.C. Code Reg., § 117-73 | "The term 'related expenses' . . . shall mean any cost incurred, directly or indirectly, in connection with investments for the production of income or future income which is or will be specifically and directly allocable under this section or costs incurred in the acquisition, sale or exchange of real, tangible, or intangible property." |
| South Dakota | No corporate income tax | |

| | | |
|---|---|---|
| Tennessee | Tenn. Rule 1320-6-1-.23(3) | "In the absence of evidence to the contrary, it is assumed that the expenses related to non-business rental earnings will be an amount equal to 50% of such earnings and that expenses related to other non-business earnings will be an amount equal to 5% of such earnings." |
| Texas | No corporate income tax | |
| Utah | Utah Code Ann. § 59-7-101(19) | " 'Related expenses' means:<br><br>(a) expenses directly attributable to non-business income; and<br><br>(b) the portion of interest or other expense indirectly attributable to both nonbusiness and business income which bears the same ratio to the aggregate amount of such interest or other expense, determined without regard to this subsection, as the average amount of the asset |



| | | |
|---|---|---|
| | | producing the non-business income bears to the average amount of all assets of the taxpayer within the taxable year." |
| Vermont | No provision | |
| Virginia | 23 VAC 10-120-20 | "The federal procedure in Treasury Reg. § 1.861-8 is applied to allocate and apportion expenses to income derived from U.S. and foreign sources." |
| Washington | No corporate income tax | |
| West Virginia | W.Va. Code § 11-24-6 (b)(2) | "There shall be added to federal taxable income, unless already included in the computation of federal taxable income . . . Interest or dividends, less related expenses to the extent not deducted in determining federal taxable income . . . . " |
| Wisconsin | Wisc. Stat. § 71.26(3)(L) | " . . . any amount otherwise deductible under this chapter that is directly or indirectly related to income wholly exempt |

| | | |
|---|---|---|
| | | from taxes imposed by this chapter or to losses from the sale or other disposition of assets the gain from which would be exempt under this paragraph if the assets were sold or otherwise disposed of at a gain is not deductible." |
| Wyoming | No corporate income tax | |



In the Matter of the Appeal of
Zenith National Insurance Corp.

No. 94A-0767
STATE BOARD OF EQUALIZATION OF THE
STATE OF CALIFORNIA

1998 Cal. Tax LEXIS 1; 98-SBE-001

January 8, 1998

COUNSEL:
Representing the Parties:

For Appellant:
Anthon S. Cannon, Jr., Attorney.

For Respondent:
Edward J. Kline, Counsel.

Counsel for Board of Equalization: Derick J. Brannan, Tax Counsel.

OPINION BY: PER CURIAM

OPINION

This appeal is made pursuant to section 19045[1] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Zenith National Insurance Corporation against proposed assessments of additional franchise tax in the amounts of $50,110.24, $199,271.49, $207,646.62 and $254,690.00 for the income years ended December 31, 1982, December 31, 1983, December 31, 1984, and December 31, 1985, respectively. The basic issue on appeal is whether interest expense incurred in connection with the issuance of corporate

[1] Unless otherwise specified, all section references in the text of this opinion are to sections of the Revenue and Taxation Code in effect for the income years in issue.

debentures should be allocated to taxable or nontaxable income for purposes of determining the deductibility of that expense.

During the subject income years, appellant owned all of the stock in the Zenith Insurance Company (hereafter ZIC). ZIC held a license to conduct insurance business in the State of California and was subject to the California tax on gross insurance premiums; as a result, ZIC dividends paid to appellant were not included in appellant's measure of tax pursuant to section 24410. (See Rev. & Tax. Code, Part 7, § 12001 et seq., and Part 11, § 23001 et seq.) Further, because section 24425 precludes a deduction for any expense allocable to a class of income which is not subject to the Bank and Corporation Tax, to the extent that appellant incurred expenses allocable to dividend income from ZIC, those expenses would not be deductible.

During the subject income years, appellant incurred significant interest expense in connection with the issuance of corporate debentures. Appellant used the debenture proceeds to develop a diverse portfolio of preferred stock. The preferred stock generated dividend income which was taxable pursuant to the California Bank and Corporation Tax, and on that basis, appellant deducted all of its debenture-related interest expense. On audit, respondent reallocated appellant's interest expense deductions between appellant's income from the preferred stock dividends and its income from the ZIC dividends. Respondent utilized a formula to allocate the interest expense in accordance with the ratio of appellant's insurance-related income (income excluded from the bank and corporation tax) to appellant's gross income



(all income whether excluded or not). Appellant disputes the use of this general allocation formula, and the basic issue on appeal is how properly to allocate, if at all, the debenture interest expense between appellant's taxable and nontaxable activities.

On September 9, 1982, appellant's Board of Directors generally discussed the infusion of additional capital into the company in order to enhance its stature and earnings. At a subsequent meeting, the Board of Directors approved the issuance of debentures with a face value of $50 million; the minutes for that meeting do not contain any reference as to the specific intended use for the debenture proceeds. However, the offering brochure which accompanied the debentures indicated as follows:

> "The offering will provide funds which will be available for general corporate purposes. A portion of the proceeds may be used for the repayment of [appellant's] or ZIC's bank indebtedness, aggregating $18,500,000 at September 30, 1982, of which approximately $3,260,000 is due in 1983. A portion of the proceeds may also be loaned or contributed to ZIC for additions to its investment portfolio or may be used by [appellant] for possible acquisitions. [Appellant] is not currently engaged in any acquisition discussions. For such purposes [appellant] may incur additional indebtedness."

In slight contrast to the general language contained in the brochure, appellant offers a number of declarations from key executives to the effect that appellant issued the debentures with the dominant purpose of investing the proceeds in preferred stock, and in turn, gaining the

federal tax advantages of the intercorporate dividend deduction.

On October 15, 1982, appellant issued debentures with a face value of $50 million and which generated net proceeds of $47,847,000. In November of 1982, shortly after it received the debenture proceeds, appellant paid off $8.5 million in short term bank debt, purchased some additional short term money market investments and advanced $15 million to ZIC; ZIC repaid those funds with interest between December 1982 and January 1983. By March 31, 1983, less than six months after it issued the debentures, appellant had amassed a portfolio of preferred stock valued at $49.6 million.

Between September and December of 1983, appellant's board increased various lines of credit and guaranteed certain indebtedness of ZIC. Thereafter, ZIC used proceeds from a loan guaranteed by appellant in order to repay a loan from appellant; ZIC also used similar proceeds to increase its own insurance reserves. In spite of this mutually beneficial financing, appellant's president testified under oath at the hearing that the debenture proceeds were "totally separable" from appellant's other banking activities, "because there really [were] no other liquid assets in the [appellant]." Further, appellant never sold any of its preferred stock to meet ZIC's financial needs.

The preferred stock portfolio remained relatively stable in value until July of 1985. At that time, appellant successfully bid $40 million for the CalFarm Insurance Company (hereafter CalFarm). Upon acceptance of its bid, appellant liquidated the preferred stock portfolio in



order to pay the bid price for CalFarm. Appellant subsequently issued its own preferred stock which raised roughly $135 million; from that money, appellant contributed $80 million to ZIC, paid $32 million to repay other bank loans and invested roughly $23 million in other short term securities and preferred stock.

During the subject income years, appellant deducted interest expense stemming directly from the debentures of $2,815,886 in 1982, $8,597,697 in 1983, $8,333,261 in 1984, and $8,439,205 in 1985. While holding the portfolio, appellant also incurred administrative and banking expenses which it claims were necessary to monitor and maintain the portfolio, and which it also seeks to deduct as allocable to the taxable income stemming from the portfolio.

Section 24425 precludes a deduction for any amount, "which is allocable to one or more classes of income not included in the measure of the [Bank and Corporation] tax." The Internal Revenue Code (hereafter IRC) contains a similar provision at section 265(a)(1), which precludes a deduction for expenses allocable to tax exempt income (other than tax exempt interest income). (*See* Treas. Reg. § 1.265-1(a)(1).) The purpose of these allocation provisions is to separate excludable income from includible income, in order that a double exemption may not be obtained through the reduction of includible income by expenses incurred in the production of wholly excludable income. (*Great Western Financial Corp. v. Franchise Tax Board* (1971) 4 Cal. 3d 1, 6.)

The parties agree that Internal Revenue Service (hereafter IRS) regulations supporting IRC section 265(a)

provide the proper test to resolve this appeal. Those regulations provide as follows:

> [1] Expenses and amounts otherwise allowable which are *directly allocable* to any class or classes of exempt income shall be allocated thereto; and [2] expenses and amounts *directly allocable* to any class or classes of nonexempt income shall be allocated thereto. [3] If an expense or amount otherwise allowable is *indirectly allocable* to both a class of nonexempt income and a class of exempt income, a *reasonable proportion* thereof determined in the light of all the facts and circumstances in each case shall be allocated to each.

(Treas. Reg. § 1.265-1(c) (1958) [emphasis added].) Appellant argues that the debenture interest expense can be *directly* allocated to the income generated by its preferred stock portfolio, and is therefore deductible. Appellant also argues that prior Board opinions establish a purpose and/or use test for determining the means by which certain expenses may be allocated to income-producing activities. Regardless of the applicable test, appellant argues that its dominant purpose for incurring the interest expense was to finance taxable activities, and that in fact, it did use the debenture proceeds for such activities.

In support of its position that this Board should look to the taxpayer's purpose in securing the debenture proceeds (and incurring the related interest), appellant refers to the *Appeal of Southern California Central Credit Union*, decided by this Board on February 3, 1965. In that case, the Board determined that the taxpayer's purpose in securing funds was to meet the demands of its credit union members for loans. Therefore, the Board allocated



the cost of borrowing such funds to business done with the members, a non-taxable activity. On that basis, the interest expense incurred in connection with those funds could not be deducted against taxable income.[2] (See also *Appeal of Los Angeles Firemen's Credit Union, Inc.*, Cal. St. Bd. of Equal., June 28, 1966.) According to appellant, if the Board applies this purpose test to the instant case, it should prevail based on the evidence of its intent at the time it issued the debentures and acquired the preferred stock portfolio.

Both parties suggest that this Board may have adopted a use test for purposes of determining the deductibility of certain expenses. Pursuant to the use test, "the question is what income did the expense in controversy help to produce, not what use was the income put to." (*Appeal of Mission Equities Corp.*, Cal. St. Bd. of Equal.,

---

[2] Respondent suggests that it is not clear that the *Appeal of Los Angeles Firemen's Credit Union, Inc., Infra*, adopts a "purpose" test. Regardless of the precise holding of that opinion, it is clear from the language of the opinion that the Board relied heavily on the taxpayer's exempt purpose for obtaining the funds in reaching a decision. Respondent further suggests that the opinion is distinguishable from the instant case because it concerns a credit union; while that factual difference is obvious, it is not significant. We are here concerned with the allocation principles discussed in that case, not the factual similarities (or lack thereof).

Jan. 7, 1975.)[3] In our opinion, the use test, arguably suggested by the *Mission Equities* decision, amounts to an accounting test which seeks to trace the application of the subject funds. We do not view that test as distinct from the purpose inquiry set forth in our other opinions. Rather, and as will be explained later, the two inquires [sic] are complementary for purposes of establishing the proper allocation of interest expense. (See *E.F. Hutton Group, Inc. v. United States* (1987) 811 F.2d 581, 584.)

Appellant also argues that various IRS pronouncements support its position. More specifically, Revenue Ruling 83-3 addresses the deductibility of expenses paid from tax exempt income; the ruling suggests certain allocation methods based on the purpose of the underlying expenditures. (Rev. Rul. 83-3, 1983-1 C.B. 72.) Appellant further cites Revenue Procedure 72-18, which discusses IRC section 265(a)(2) and sets forth guidelines for allocating indebtedness and the related interest expense between tax-exempt securities and other taxable activities. That procedure implements the allocation process by focusing on the taxpayer's purpose in acquiring the indebtedness as demonstrated by all of the facts and circumstances, including the actual use of the debt proceeds. (Rev. Proc. 72-18, 1972-1 C.B. 740; see also Treas. Reg. § 1.265-2(a).)

---

[3] After enunciating this rule, the Board based its final determination on the fact that the taxpayer's subsidiary had already deducted expenses in connection with the excluded income. For that reason, the Board found that it would be improper to allow a double deduction, one for the subsidiary and one for the parent, in connection with the same income.



In contrast to appellant's position, respondent argues that interest, by its nature, is not susceptible to direct allocation. In other words, respondent contends that because money is fungible, such that money generated from two distinct sources is indistinguishable once it is placed in the same fund, any determination regarding the purpose or use of the debenture proceeds will be tenuous at best, and of only limited value for allocation purposes. Further, because the interest expense stems from money which is subject to the discretionary use of the taxpayer, the interest expense simply cannot be directly allocated to a particular class of income, rather, the expense contributes to all aspects of the corporate operations. (See *Appeal of Pacific Associates, Inc.*, Cal. St. Bd. of Equal., Feb. 2, 1976.) For these reasons, when applying Treasury Regulation section 1.265-1(c), *supra*, respondent argues that interest may only be *indirectly* allocated by way of a formula which allocates a reasonable portion of the interest expense to both taxable and nontaxable of income.

Respondent also argues that appellant's various uses of the debenture proceeds for items unrelated to the preferred stock, such as the short term loan to ZIC or the CalFarm purchase, demonstrate that appellant never intended to restrict those funds to one taxable purpose. Respondent also contends that these additional transactions support its position that the associated interest expense is difficult (if not impossible) to allocate between appellant's various income-producing activities. Finally, according to respondent, the fact that appellant chose not to use the proceeds from the preferred stock to retire the debentures constitutes further evidence that appellant

intended to use the funds for both taxable and nontaxable purposes.

Each party presents valid arguments in support of its position, and each argument is founded upon meritorious considerations. It is our opinion that the principles set forth in Revenue Procedure 72-18 best implement all of those considerations, will provide the most workable solution over the long term, and are not inconsistent with our existing opinions in this area. Revenue Procedure 72-18 focuses on the taxpayer's dominant purpose for *incurring and continuing* the subject indebtedness, but also considers the actual use of the debt funds as strong evidence of that purpose.[4] "Direct evidence of a purpose to purchase tax-exempt obligations [or taxable investments] exists where the proceeds of indebtedness are used for, and are directly traceable to, the purchase." (Rev. Proc. 72-18, *supra,* § § 3.02 and 3.03.)

In the absence of direct evidence linking indebtedness with a particular purchase, the IRS, and this Board, will determine whether the totality of the facts and circumstances establish a sufficiently direct relationship between the borrowing and the investment to allow for a direct allocation between those two items. (Rev. Proc. 72-18, *supra,* § 3.04.) Unless the taxpayer can establish its

[4] We understand that IRC section 265(a)(2), by its terms, applies to tax exempt obligations and does not necessarily apply to the case at hand. However, we also note that section 265(a)(2) and its supporting regulatory scheme concern the allocation of interest expense between taxable and nontaxable activities. For that reason, we find that Revenue Procedure 72-18, and the principles upon which it relies, provide the most helpful framework within which to resolve the present case.



dominant purpose and a sufficiently direct relationship between the expense and the income, respondent's allocation formula will provide the best means to allocate interest expense between taxable and nontaxable activities. Further, due to the factual nature of the inquiries presented by this analysis, it is also clear that the taxpayer must carry the general burden of proving its dominant purpose for incurring and/or continuing the subject obligations (and the related interest expense), as well as the burden of demonstrating the actual use of the subject funds, by tracing or some other method.

Applying these rules to the instant case, we find that appellant has established a dominant purpose sufficient to allow for a direct allocation of its interest expense for the 1982, 1983 and 1984 income years, but has not done so with regard to the 1985 income year.

Regarding 1982, 1983 and 1984, the declarations submitted by appellant, as well as the live testimony of appellant's president, clearly establish appellant's motivation for incurring, and continuing, the debenture interest expense as well as its intentions for the debenture proceeds. That motivation is further established by the uncontroverted evidence that appellant used all of the debenture proceeds to acquire a portfolio of preferred stock within six months of the debenture issue date. Because appellant realized taxable income from that preferred stock, the interest incurred in carrying the debenture obligations is directly allocable to the taxable income generated by the preferred stock portfolio, and is therefore deductible.

Respondent argues that appellant's use of the debenture funds to support ZIC during the 1983 income year, either through direct financing or through loan guarantees, is inconsistent with appellant's asserted dominant purpose. Respondent's point is not without merit; however, a temporary diversion of funds will not, of itself, alter the dominant purpose for incurring the indebtedness represented by the debentures. (Rev. Proc. 72-18, *supra*, § 3.02.) Further, once purchased, appellant never sold any of the preferred stock in order to finance the loans to ZIC, and each of the subsequent loans to ZIC generated *taxable* interest income at the market rate. Finally, the simultaneous pursuit of two activities is not, in and of itself, sufficient to trigger a disallowance of the expense under the applicable statute; the taxpayer may still offer sufficient evidence to allow for a direct allocation. (*Handy Button Machine Co. v. Commissioner* (1974) 61 T.C. 846, 852.)

Respondent points out that interest is traditionally considered an indirect expense for financial accounting purposes, which by definition cannot be directly allocated to a particular item or activity. First, financial accounting is distinct from tax accounting and will take us only so far in arriving at a legal conclusion. Second, we recognize that the distinction between direct and indirect expenses, and the allocation of those expenses, can be difficult. However, such complexities should not preclude a taxpayer from presenting sufficient evidence to obtain a proper tax benefit; slavish adherence to somewhat arbitrary rules should not come at the cost of the



correct result.[5] Finally, respondent suggests that its reasonable formula provides certainty and eases its administrative burden. While formulas are often easier to implement, the burden of producing evidence sufficient to demonstrate the requisite dominant purpose still rests with the taxpayer; therefore, we conclude that our holding does not unnecessarily add to respondent's existing administrative burden.

As to the 1985 income year, we are not satisfied that appellant maintained, or continued with, the dominant purpose sufficient to allocate the subject interest expense entirely to income from its "taxable" activities. The facts demonstrate that appellant sold nearly all of its preferred stock portfolio in order to acquire CalFarm; it did not use the proceeds to retire the debentures, rather, it acquired yet another insurance company whose income is not subject to the California Bank and Corporation Tax. After liquidating the preferred stock portfolio, appellant issued its own preferred stock and raised roughly $135 million. Of that amount, appellant contributed $80 million to ZIC, repaid $32 million in other bank loans and invested roughly $23 million in other short term securities and preferred stock. The record does not contain a detailed breakdown of the type of securities acquired by appellant, but it is evident that the nature of appellant's holdings changed dramatically as a result of the CalFarm

[5] While it should be evident, this rule may also operate to the detriment of a taxpayer whose purpose in incurring certain debt is sufficiently clear that the related interest expense may be directly allocated to tax exempt income.

acquisition. In short, we lose sight of the debenture proceeds in 1985. For that reason we are no longer content to rely on appellant's original dominant purpose for continuing the debt, and we find that the interest expense is no longer directly allocable to income from appellant's taxable activities. For these reasons, appellant's 1985 interest expense should be allocated in accordance with the formula utilized by respondent in arriving at its assessment for that income year.

As one final matter, the parties also dispute the proper allocation of administrative expenses incurred by appellant in connection with the debentures and the preferred stock portfolio. We find that these expenses should be allocated in the same manner as the interest expense based on the rationale set forth above.

Based upon the above analysis and factual conclusions, we hereby reverse respondent's determination as to the 1982, 1983 and 1984 income years, and affirm its determination as to the 1985 income year.

*ORDER*

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED, AND DECREED, pursuant to section 19047 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Zenith National Insurance Corporation against proposed assessments of additional franchise tax in the amounts of $50,110.24, $199,271.49, and $207,646.62 for the income years ended December 31, 1982, December



31, 1983, and December 31, 1984, respectively, be and the same is hereby reversed, and that the Franchise Tax Board's action on the protest against the proposed assessment of $254,690.00 for the income year ended December 31, 1985, be sustained.

Done at Sacramento, California, this 8th day of January, 1998, by the State Board of Equalization, with Board Members Mr. Andal, Mr. Klehs, Mr. Dronenburg, Mr. Halverson* (not participating) and Mr. Chiang** present.

---

* For Kathleen Connell, per Government Code section 7.9.

** Acting Member, 4th District.

In the Matter of the Appeal of
Zenith National Insurance Corp.

No. 94A-0767

STATE BOARD OF EQUALIZATION OF THE
STATE OF CALIFORNIA

1998 Cal. Tax LEXIS 651; 98-SBE-001-A

June 25, 1998

OPINION BY: PER CURIAM

*ORDER DENYING PETITION FOR REHEARING*

Upon consideration of the petition filed February 3, 1998, by the Franchise Tax Board for a rehearing of appellant's appeal from the action of the Franchise Tax Board, we agree that our prior opinion dated January 8, 1998, is subject to clarification and we take this opportunity to do so.

As indicated in our opinion of January 8, 1998, interest expense shall be allocated between taxable and tax-exempt income in accordance with the principles set forth in Revenue Procedure 72-18. (Rev. Proc. 72-18, 1972-1 C.B. 740.) Acknowledging that the preferred stock portfolio in the instant case remained relatively stable in value until July of 1985, and consistent with the principles set forth in Revenue Procedure 72-18 it is clear that appellant maintained the same dominant purpose through June of 1985, and that appellant's allowable interest expense for the 1985 income year should be decreased in the manner proposed by both parties.

Regarding respondent's request that we modify the language at page four, paragraph three, line two, of the opinion to refer specifically to Internal Revenue Code



section 265(a)(1), rather than to section 265(a), we express no opinion as to the merits of that suggestion, but choose not to amend our opinion in that regard.

Aside from the clarifications contained in this order, we are of the opinion that none of the grounds set forth in the petition for rehearing constitute cause for the granting thereof and, accordingly, it is hereby ordered that the petition be and the same is hereby denied, and we direct that our order of January 8, 1998, be and the same is, hereby affirmed.

Done at Sacramento, California, this 25th day of June, 1998, by the State Board of Equalization, with Board Member Mr. Andal, Mr. Klehs, Mr. Dronenburg and Mr. Chiang* present, Ms. Mandel** not participating.

---

* Acting Member, 4th District.

** For Kathleen Connell, per Government Code section 7.9.